Integrated Reporting and Key Performance Indicators[1]

Steve Lydenberg and Jean Rogers

The number of companies issuing corporate social responsibility (CSR) reports has seen remarkable growth since the early 1990s. According to the CorporateRegister.com, only 26 companies published CSR reports in 1992, but by 2008 that number had risen to over 3,000.

This worldwide momentum for increase disclosure of data relating to corporate sustainability records and impacts—data relating to the environmental, societal, and governance (ESG) policies and performance of these companies—raises two important questions:

1. Should ESG reporting be mandatory and integrated into financial reporting?
2. How are users of ESG data best able to identify the most meaningful ESG data for specific companies and industries?

In this paper we argue that ***mandatory, integrated reporting is desirable*** and then turn our attention to the question of ***how key performance indicators (KPIs) can be used to identify sustainability data points that can be most usefully disclosed industry by industry****.* This paper proposes a ***process*** for identifying these KPIs, and leaves to future research identification and agreement on specific industry KPIs.

Need for Mandatory, Integrated Reporting

Currently voluntary sustainability reporting has a number of shortcomings. Companies often report on different sustainability indicators, use different formats and metrics for these indicators, and choose different time periods for their reporting. Standardized mandatory ESG reporting can address these shortcomings. Mandatory integrated reporting is desirable because it:

- Allows investors and others to make apples-to-apples comparisons
- Creates a level playing field on which corporations can base their disclosure
- Enables the full range of stakeholders to assess and debate corporate performance
- Helps companies internalize the costs of their activities that they currently externalize

With comprehensive, mandatory reporting, third parties—including investors, regulators, employees, and community and environmental groups—can fairly judge companies' sustainability policies and practices; compare them to those of their corporate peers; assess

[1] This article is based on the white paper *From Transparency to Performance: Industry-Based Sustainability Reporting on Key Issues* by Steve Lydenberg, Jean Rogers, and David Wood

This article is reproduced as an excerpt from "The Landscape of Integrated Reporting: Reflections and Next Steps" edited by Robert G. Eccles, Beiting Cheng, and Daniela Saltzman, 2010 (c) President and Fellows of Harvard College. The free ebook may be downloaded at http://www.hbs.edu/environment/integratedreporting/ebook/ and distributed for non-commercial purposes.

their progress or lack thereof; and understand the relationship of companies' social and environmental initiatives to governments' efforts to create just and sustainable societies.

Integrated reporting means two things—combining ESG reporting with financial reporting so that investors can make better buy/sell decisions, and integrating considerations of corporations' societal and environmental sustainability with considerations of the economic value these companies bring to society. Ultimately, it is crucial that these various parties be able to integrate evaluations of corporations' societal and environmental policies and practices into financial decisions, the day-to-day management of these firms, and the regulation of their interactions with their stakeholders.

Voluntary ESG disclosure will not be sufficient to provide systematic, comparable data or to integrate diverse societal and environmental considerations into the evaluation of corporations' relationships with all its stakeholders. Mandatory, integrated ESG reporting will therefore be necessary.

In the U.S., the SEC recently issued interpretive guidance on the materiality of climate change, stating that it is already a requirement to report on issues of material significance in the Form 10-K (thereby in effect defining the Form 10-K as a mechanism for integrated reporting). Therefore, one might argue that reporting on material sustainability issues is already mandatory for listed companies—what is more urgent, therefore, is reaching agreement on what issues are material, by sector, and providing clear guidance to reporters.

Challenges of Integrated Reporting

If one accepts that reporting on the risks and opportunities associated with material, sustainability issues is already required (at least for listed companies in the U.S.), then why isn't it happening with more frequency and consistency? Currently, there is a lack of understanding regarding how to determine the materiality of sustainability issues by CFOs and those responsible for financial disclosure to the SEC, and there is no clear guidance on how to translate these issues into performance indicators. This frustrates reporters and stakeholders alike:

- Companies struggle with interpreting the concept of materiality as applied to sustainability issues.
- Companies can expend substantial time and expense gathering data irrelevant to their primary societal and environmental impacts.
- CSR reports can contain extraneous information, confusing to stakeholders and detracting from the most fundamental challenges faced by the firm.
- Companies can be at the mercy of ever-increasing requests for information from and ever-increasing number of interested parties.

- Companies with prominent brands can be subject to disproportionate pressures to increase their reporting.

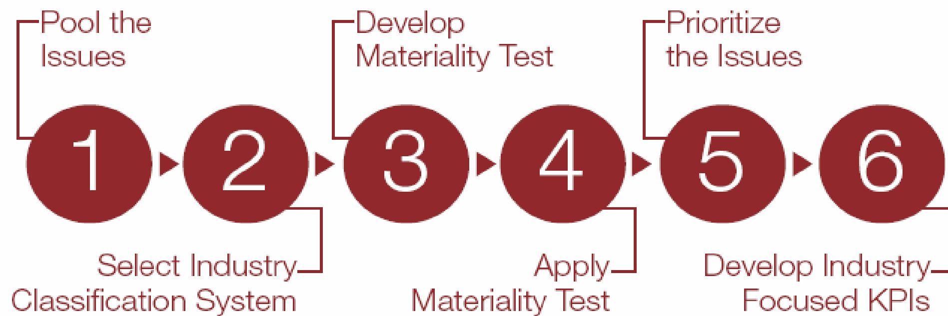
KPIs Can Address These Challenges

By focusing corporate CSR reporting on sustainability Key Performance Indicators (KPIs), these challenges can be addressed. Properly conceived and identified, sustainability KPIs focus the attention of investors, managers, and other stakeholders on the issues most material to the business model and financial prospects of the corporation, as well as on its most important impacts on society and the environment. A focus on material KPIs frees corporate executives' time for the management of these issues; allows investors to assess management's effectiveness in addressing these issues, which are often complicated and long-term in their implications; and helps employees, customers, communities, and civil society organizations to better understand how companies can minimize their negative externalities on society and maximize their positive externalities, while simultaneously remaining profitable. If material KPIs are agreed within a sector, then reporting becomes comparable and benchmarkable for all companies within a sector. This encourages analysts to interpret sustainability performance with respect to inherent challenges faced by the sector, and enables companies to understand how to drive competitive advantage by improving sustainability performance.

Process for Identifying Material KPIs

A properly conceived process will identify material KPIs that produce comparable data for firms in comparable industries; data that highlights the key challenges and opportunities when it comes to issues of substantial societal and environmental relevance for the particular subsector in which a company operates. We have identified a six-step process that we believe can successfully identify these sector-specific sustainability KPIs.

The following describes this process. (We have not dealt with the complicated issue of who would have the authority to impose mandatory reporting, by sector, of the most material KPIs.) The process of determining the material KPIs, however, can be undertaken by any organization wishing to provide more substantial guidance to corporations regarding how to best meet disclosure requirements relative to material sustainability issues facing their industry. Material KPIs can be determined industry by industry, however, there is value in looking at the entire set of industries and mapping the relative materiality of sustainability issues. Understanding the relative significance of sustainability issues by sector points to implications for governments and industry groups: policy initiatives, funding, and R&D to address global and regional issues such as water scarcity or climate change can be directed in the most impactful way according to the sectors that are most affected.



Step One: Assemble a broad universe of sustainability risk and opportunity factors that could apply to all industries. The existing body of work on enhanced corporate sustainability reporting offers an excellent pool of issues from which to work.

For example, the Global Reporting Initiative has developed a particularly rich set of issues from which one can work. These include issues most relevant to the full range of stakeholders including customers, communities, employees, the environment, investors concerned with governance, and supply chain.

Step Two: Select an industry classification system. A number of industry classification systems already exist. One of the best known is the Industry Classification Benchmark, jointly developed by Dow Jones Indexes and FTSE. The ICB Universe Database identifies 114 industry subsectors into which it categorizes 60,000 companies worldwide.

For example, the Basic Materials industry is divided into two Supersectors (Chemicals and Basic Resources). Basic Resources is then divided into three Sectors (Forestry & Paper, Industrial Metals & Mining, and Mining), each of which is further subdivided. Mining, for example is divided into five subsectors: Coal; Diamond & Gemstones, General Mining, Gold Mining, and Platinum & Precious Metals. It is at this subsector level that KPIs must ultimately be developed and applied.

Step Three: Establish a definition of materiality for non-financial issues. The next step is to extract from the universe of sustainability indictors those that are most material to assessing the performance of each of the 114 subsectors. This materiality test should include five factors:

1. Financial impacts and risks—societal and environmental factors that may have financial implications
2. Legal, regulatory, and policy factors—emerging government policy or regulatory issues (e.g., carbon emissions regulations)
3. Peer-based norms—sustainability issues generally recognized and reported by companies within the subsector (e.g., safety in the airline industry)

4. Stakeholder concerns and societal trends—issues of high importance to stakeholders (e.g., genetically modified ingredients for consumers of food products)
5. Opportunities for innovation—issues where companies can demonstrate industry leadership in finding innovative solutions to environmental, customer, or other stakeholder challenges.

Step Four: Apply the materiality test to the sustainability issues potentially applicable to each subsector of each industry. For each subsector of each industry, score the full range of sustainability issues according to their relevance for each of the five aspects of materiality.

For example, for the airline industry the issue of energy efficiency in fuel usage has substantial financial implications, may soon become subject to regulatory mandates, is widely reported on by specific airlines, is of substantial concern to environmentalists, and presents major opportunities for innovation in the identification of alternatives to conventional jet fuel. It therefore scores high on the materiality test.

Step Five: Rank the materiality scores of these issues within each industry and establish a threshold that defines those issues that are most key. Once the materiality test has been applied to the broad set of sustainability issues, draw a line that establishes an acceptable threshold for key materiality.

For example, within the airline industry, fuel efficiency, climate change management, safety, impact on communities, customer satisfaction, and labor relations would in all likelihood be among the highest scoring sustainability KPIs.

Step Six. Create a tailored set of metrics for each of the KPIs that are most material for each subsector of each industry. Finally, it is necessary to determine for each of the sustainability KPIs what the appropriate unit of comparative measurement would be.

Again for the airline subsector of the transportation industry, the most appropriate metrics might be customer miles flown per gallon of fuel consumed for fuel efficiency; total annual carbon emissions in metric tons for climate change management; fatal and non-fatal airplane crashes per miles flown over the past decade for safety; jet engine noise levels for impact on communities; rankings in customer satisfaction surveys for customer satisfaction; and percentage of workforce unionized and number and length of strikes for labor relations.

Results of KPI Selection Process

The KPI selection process described above will result in metrics for the measurement of somewhere between 10 and 20 sustainability KPIs for each of the 114 subsectors. Companies in these subsectors can then be required to report on their performance according to the metrics established for the KPIs in each subsector, as a minimum basis for disclosure of material sustainability issues.

These KPIs will differ from one subsector to another, but they will be a manageable number for each subsector, both from the point of view of corporations gathering and reporting on the KPIs and from the point of view of stakeholders seeking to evaluate overall company performance on the basis of these KPIs.

Importantly, they will reflect the most material issues faced by the sector, allowing benchmarking of companies within a sector, and—ultimately—performance improvement on the things that really matter.

Some of the KPIs will repeat across multiple, and possibly even all, subsectors, while other KPIs will be relevant for a limited number of subsectors, or possibly even a single subsector.

Next Steps

The definition of a process for establishing KPIs will inevitably be a part of the larger debate about integrated reporting and how most efficiently and effectively the goal of widespread disclosure on material sustainability issues can be reached.

Our report left for further exploration the challenging question of what organizations or regulatory bodies are best qualified to establish material KPIs by sector, and maintain them over time. In an appendix to the report we suggest that three types of organizations logically suited for the task are accounting bodies such as the International Accounting Standards Board or the Financial Accounting Standards Board; governmental and trade-association regulatory bodies such as the Securities and Exchange Commission and the Financial Industry Regulatory Authority in the United States; and national or regional stock exchanges, which could establish the disclosure of sustainability KPIs as a listing requirement, much as the JSE (Johannesburg Stock Exchange) has already done.

In addition, we noted that the Global Reporting Initiative has already taken important steps toward the identification of KPIs for sectors and subsectors through its sector supplement series of guidelines.

As the reach and scope of corporations around the world continues to grow and their influence continues to extend into many sectors of our lives, it is only natural that increased disclosure of their impacts upon society and the environment, as well as the risks and opportunities that global sustainability challenges present to the corporation will be addressed as part of mandated disclosure requirements. That disclosure must be rigorous and comprehensive in order to assure an accurate assessment of these impacts and drivers of change. At the same time, it must be balanced and focused, to assure that corporations, their stakeholders, and regulators can appropriately focus on the most important of these sustainability impacts. Balancing these two important requirements will be among the

challenging next steps to be taken in the development of mandatory, integrated ESG disclosure regimes.

Steve Lydenberg is the Chief Investment Officer at Domini Social Investment LLC. He has been active in social research since 1975 and was a founder of KLD Research & Analytics, Inc. He has written numerous publications on issues of corporate social responsibility and responsible investing, including "Corporations and the Public Interest."

Jean Rogers PhD is a Principal at Arup in San Francisco. She leads the management consulting practice in the Americas Region and works with global clients in a broad array of industries to integrate sustainability into their projects and operations. She is a registered professional engineer and a former Loeb Fellow at Harvard University.